FRBSF Weekly Letter

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The Largest Debtor Nation

During 1985, the United States became a net international debtor for the first time since World War I. At the present rate of net capital inflow and foreign debt accumulation, U.S. net international indebtedness should reach $150 billion by the end of this year — well above the amounts owed by such well-known debtor nations as Brazil and Mexico. With continuing annual net capital inflows, further deep declines in the U.S. international investment position beyond 1986 can be expected.

Because of its implications for the U.S. and world economies, this development has created considerable concern. Some of the factors underlying the recent trend in the U.S. investment position are reviewed in this *Letter*. The *Letter* also discusses the welfare and policy implications both at home and abroad of increasing U.S. indebtedness. It concludes that whether the emergence of the United States as a net international debtor is cause for concern depends on how the incoming funds are spent and on how rapidly U.S. debt is rising in relation to what foreigners have available to invest.

International investment position

The net international investment position is a balance sheet measure of the difference between a country's accumulated stocks of foreign assets and liabilities. U.S. foreign assets consist of claims on foreigners held by the U.S. government as well as foreign direct and portfolio investment assets held by U.S. firms and residents. U.S. foreign liabilities include the liabilities of the U.S. government to foreigners, and also direct investment and portfolio investments of foreigners in this country. While the distinction between direct and portfolio investment is sometimes arbitrary, the former generally refers to investments by firms in existing or newly acquired foreign affiliates, and the latter, to investments in foreign corporate bonds, stocks, and other securities where there is no effective control by the investor over the use of the funds invested.

Foreign assets and liabilities change from year to year as the result of both international capital flows and valuation changes. Capital outflows arising from the acquisition of foreign assets (lending) improve the net international investment position, while capital inflows arising from the issuance of liabilities to foreigners (borrowing) worsen the position. Valuation adjustments are made each year to reflect fluctuations in securities prices and exchange rates.

The trend

The United States has been a net international creditor for most of this century. Its net international investment position improved steadily following World War I from $6 billion in 1919 to $147 billion in 1982. Initially, the improvement was due to increases in U.S. government assets abroad associated with foreign credits and loans; in the 1950s and 1960s, it was due to the growth of foreign direct investment by U.S. firms; and, in the late 1970s, to the rapid rise in U.S. foreign bank loans.

The long-term rise in the U.S. net investment position reversed dramatically after 1982. From the peak level of $147 billion in 1982, the U.S. net investment position deteriorated so severely in the following three years that, in 1985, the United States became a net international debtor in the amount of about $50 billion.

How did this turnabout occur so rapidly? In general terms, the deterioration in the investment position is the result of massive net capital inflows associated with the liquidation of U.S. foreign assets and the accumulation of foreign debt in the U.S. capital account. These inflows are the counterpart of the current account deficits that have also risen sharply since 1982. The current account measures trade in goods and services (and transfers), and deficits in that account imply that the United States has been able to spend substantially more on goods and services than it has produced. Since international payments flows must balance, the difference has matched the net inflow of funds in the capital account.

The chart illustrates recent changes in the net U.S. international position, disaggregated by net U.S. government assets, direct investment, and portfolio investment. All three net investment categories have deteriorated since 1982. The net direct investment position fell some $25 billion between 1982 and 1985 as U.S. direct investment abroad slowed and foreign direct investment in this country surged. The net portfolio and U.S. government positions declined even more significantly, by approximately $125 billion and $50 billion, respectively, as bank lending abroad dropped sharply and foreign purchases of U.S. Treasury securities and U.S. private securities increased substantially.

The decline in bank lending can be attributed to several factors: sluggish loan demand in Europe, particularly in 1983 and 1984; a desire by banks to limit their overseas exposure as a reaction to the debt repayment problems of borrowing countries; and declining credit demand by oil-importing developing countries due to a falling price for oil. Factors inducing the foreign purchase of U.S. securities included the high rates of return generated by U.S. government budget deficits, and, to a lesser extent, the view that the U.S. political climate provided a "safe haven" for investments.

How serious is it?

While the downward swing in the U.S. investment position is clear, the magnitude of this swing has been exaggerated to some extent. Net U.S. bank lending was inflated by roughly $20 billion between 1981 and 1982 as the result of the establishment of International Banking Facilities which allowed foreign bank loans to be shifted from offshore banking affiliates to the books of banking offices in the United States. In addition, net bank loans were reduced greatly in 1983 and 1984 essentially because of a contraction in interbank lending prompted by stronger domestic capital requirements.

There are also reasons to question the accuracy of the reported figures. On the one hand, U.S. assets abroad are certainly understated because direct investment assets and U.S. official gold holdings are carried at book rather than market value. On the other hand, there is reason to believe that U.S. liabilities are understated as well, first because of book valuation of foreign direct investment liabilities, and second because of unreported capital inflows.

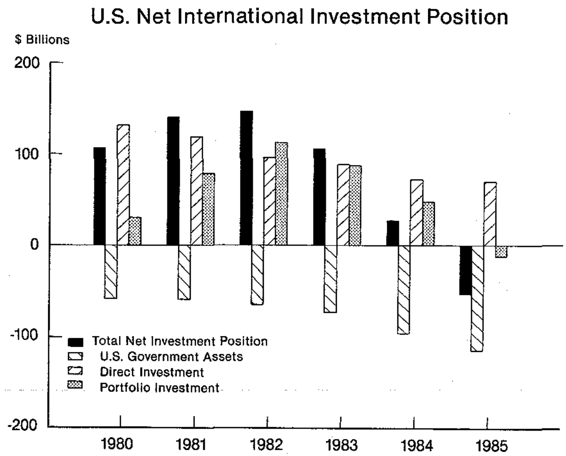
Estimates of adjustments to the reported figures, particularly for direct investment, that take these considerations into account improve the current U.S. international investment position (on balance) by roughly $200 billion. They imply that the United States may still be a net creditor at this time. Nevertheless, at the current rate of debt accumulation, there is little doubt that even with this adjusted investment position figure, the United States will soon turn into a net debtor.

Implications

From the United States' point of view, the net capital inflows and increased U.S. liabilities to foreigners have augmented the pool of savings available to finance private business investment and the federal budget deficit. Without such an inflow, U.S. interest rates would have been higher, the budget deficit would have crowded out investment much more severely, and recent economic growth would have been dampened, if not completely eliminated. In the longer run, however, the increased liabilities to foreigners will result in greater interest and dividend payments to foreigners and a corresponding drain on U.S. economic resources. Net U.S. income receipts have generally fallen in recent years as payments have risen in association with the declining net investment position.

Whether the initial capital inflows from abroad impart longer term benefits on the U.S. depends on whether the funds generate investment in ways that increase output and employment for domestic residents more than they cost in terms of interest paid out. It is difficult to tell the extent to which these funds themselves have been invested or have served to free up U.S. domestic savings for investment. U.S. domestic real investment was relatively strong in 1983 and 1984 but has since leveled off. If incoming funds result in consumption or other "non-productive" expenditures, there are no long-term benefits, only costs in the form of the interest payments that reduce the income available for future domestic consumption and investment.

The net welfare effect of the capital inflows depends on the balance between increased current consumption and reduced future consump-



tion. Reducing the build-up of debt is appropriate if the discounted value of lost future consumption is high and if it is deemed undesirable to compel future generations to bear all the costs of sustaining current consumption levels.

Another possible concern is that the buildup of U.S. foreign debt will increase the vulnerability of the U.S. economy to foreign economic shocks and further constrain policymakers who must respond to these shocks. Many fear that the United States will become overly sensitive to changes in risk perceptions by foreigners who hold assets in this country. A sudden loss in confidence in U.S. creditworthiness, it is argued, could cause a sharp fall in the dollar, a recession in the United States, and a global financial crisis as the Federal Reserve Board is forced to raise interest rates to support the dollar.

The likelihood of such a shift in the asset preferences of foreigners depends on the implications of the build-up of U.S. debt from the point of view of the rest of the world. Clearly, the U.S. capital inflows and trade deficits helped to end the recession in the world economy several years ago by stimulating economies abroad. In addition, the U.S. trade deficits helped developing countries generate the exports with which to service their own debts. However, the capital inflows have also siphoned off funds that could have been invested abroad.

Until now, the willingness of foreign investors to invest in U.S. assets has merely been a rational response to the greater returns expected in the U.S. relative to investments in other countries. Assuming U.S. real interest rates remain at their current levels, whether foreigners will continue to accumulate U.S. assets depends on their perceptions of U.S. creditworthiness and on their own rate of savings.

The United States likely will be able to service its repayment obligations as long as the U.S. economy continues to prosper and grow. In addition, because U.S. debts are primarily denominated in dollars, the burden of repaying these debts is much less than that of countries that borrow in terms of currencies not their own and who consequently bear exchange risk.

Nevertheless, even if creditworthiness concerns are not warranted, one must ask what proportion of their savings foreigners are willing to continue to invest in U.S. assets. One estimate is that global net savings outside of the United States and the rise in foreign wealth amount to $1 trillion annually. The allocation of 10 percent of this pool of savings to additional U.S. assets each year would be sufficient to finance continuing current account deficits of $100 billion. Since the United States accounts for roughly a quarter of gross world product, the willingness of foreigners to allocate their savings in this manner, while historically unprecedented, is not inconceivable.

If the magnitude of U.S. foreign capital inflows causes U.S. assets to become a steadily increasing proportion of foreign portfolios, however, foreigners will ultimately reach a limit to their willingness to accumulate U.S. debt. Under such a circumstance, it would be essential to reduce U.S. capital inflows and the corresponding current account deficits to limit the proportion of U.S. liabilities in foreign portfolios. A decline in the value of the dollar would contribute towards the achievement of this goal.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author .... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/22/86	Change from 1/15/86	Change from 1/23/85 Dollar	Change from 1/23/85 Percent[7]
Loans, Leases and Investments[1] [2]	200,681	−2,234	13,123	6.9
Loans and Leases[1] [6]	181,312	−2,261	11,800	6.9
Commercial and Industrial	52,202	− 372	98	.1
Real estate	65,901	− 78	3,755	6.0
Loans to Individuals	38,531	− 87	6,130	18.9
Leases	5,692	− 2	422	8.0
U.S. Treasury and Agency Securities[2]	10,838	52	− 219	− 1.9
Other Securities[2]	8,531	− 24	1,541	22.0
Total Deposits	201,369	−2,608	9,353	4.8
Demand Deposits	48,997	−1,928	5,637	13.0
Demand Deposits Adjusted[3]	31,162	−2,161	3,249	11.6
Other Transaction Balances[4]	14,804	− 435	2,271	18.1
Total Non-Transaction Balances[6]	137,568	− 245	1,447	1.0
Money Market Deposit Accounts—Total	45,875	− 138	2,860	6.6
Time Deposits in Amounts of $100,000 or more	38,034	− 100	− 1,829	− 4.5
Other Liabilities for Borrowed Money[5]	26,713	627	6,806	34.1

Two Week Averages of Daily Figures	Period ended 1/13/86	Period ended 12/30/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	107	97
Borrowings	3	84
Net free reserves (+)/Net borrowed(−)	104	14

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change